No. 87-1140

FILED
MAR 17 1988

In the Supreme Court of the United States

OCTOBER TERM, 1987

JOYCE PURCELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Page

Cases:

Douglas v. *Commissioner*, 86 T.C. 758 (1986) 6
Resnick v. *Commissioner*, 63 T.C. 524 (1975) 3
Shenker v. *Commissioner*, 804 F. 2d 109 (8th Cir. 1986), cert. denied, No. 86-1247 (May 26, 1987) 4, 5, 6, 7
Sivils v. *Commissioner*, 86 T.C. 79 (1986) 6

Statutes:

Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 424, 98 Stat. 803 3
Internal Revenue Code (26 U.S.C.):
§ 165(g) 2, 7
§ 6013 ..... 5, 7
§ 6013(e) 1, 2, 3
§ 6013(e)(1) 3
§ 6013(e)(1)(B) 3
§ 6013(e)(2)(B) 3

Miscellaneous:

H.R. Rep. 98-432, 98th Cong., 2d Sess. Pt. 2 (1984) 5

In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-1140

JOYCE PURCELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner contends that the court of appeals erred in rejecting her claim for "innocent spouse" relief under Section 6013(e) of the Internal Revenue Code.[1]

1. Petitioner filed joint tax returns for 1977 and 1978, the tax years in issue, with W. Bruce Purcell, who was her husband from 1952 until their divorce in 1982 (Pet. App. 27-28). The Purcells each owned 25% of the outstanding stock of International Demolition and Salvage Company, Inc., a corporation formed in 1974 of which petitioner was the treasurer and a director. The corporation, which had a sustained history of losses, was in financial straits in 1977 and 1978, and ultimately it failed. In 1976, 1977, and 1978, Bruce Purcell and other shareholders made advances to International Demolition, which were treated on the

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code, as amended (26 U.S.C.) (the Code or I.R.C.).

corporate books as loans to the corporation. In 1980, Bruce Purcell transferred his stock in International Demolition to a third party for $10, pursuant to an agreement providing that the third party would assume the corporation's management and debts. *Id.* at 29, 61.

A certified public accountant prepared the Purcells' joint income tax returns for 1977 and 1978. Petitioner furnished the accountant with information relating to medical expenses, charitable contributions, and other types of personal items. The accountant received most of the other information used in preparing the returns from the comptroller of International Demolition, but he occasionally requested information from Bruce Purcell if the comptroller could not furnish the information. Although the accountant did not audit the records furnished to him, he believed that he had sufficient information to prepare the returns correctly. Pet. App. 29-30.

On their joint returns, the Purcells claimed deductions for nonbusiness bad debts with respect to International Demolition in the respective amounts of $144,411 for 1977 and $95,185 for 1978. They also claimed a long-term capital loss during 1977 in the amount of $26,905 due to the asserted worthlessness of their stock in International Demolition (see I.R.C. § 165(g)). On audit, the Commissioner disallowed these deductions for failure to establish that the debts and stock became worthless during the years in issue. Pet. App. 31.

2. Petitioners sought redetermination of the deficiencies in the Tax Court. While the case was pending, Congress retroactively amended the "innocent spouse" provision of Section 6013(e) of the Code. That provision permits a spouse who files a joint return to escape liability for the understatement of tax on the return under certain circumstances. Under the amended version applicable here,

one relevant factor is whether the understatement is "attributable to grossly erroneous items of one spouse" (I.R.C. § 6013(e)(1)(B)). "Grossly erroneous items" are defined to include "any claim of a deduction * * * in an amount for which there is no basis in fact or law" (I.R.C. § 6013(e)(2)(B)).[2] Petitioner sought relief under the amended statute. Conceding the correctness of the Commissioner's adjustments, she argued that the deductions constituted "grossly erroneous items."

The Tax Court denied petitioner innocent spouse relief with respect to the worthless stock and bad debt deductions, though it granted that relief with respect to certain other items (Pet. App. 55-97; 86 T.C. 228).[3] The court held that the various stock and bad debt deductions could not form the basis for innocent spouse relief because they

---

[2] Section 424 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 803, renders the amendment effective retroactively (for the benefit of taxpayers) for all taxable years to which the Internal Revenue Code of 1954 applies. Under prior law, relief under Section 6013(e) had been limited to instances in which understatements of tax were caused by omissions from gross income, which would not cover this case where the understatement was due to deductions that were disallowed. See, *e.g.*, *Resnick* v. *Commissioner*, 63 T.C. 524, 527 (1975). The spouse seeking relief under the amended statute must also establish that in signing the return he or she did not know or have reason to know that there was a substantial understatement of tax and that it would be inequitable to hold him or her liable for the deficiency. I.R.C. § 6013(e)(1).

[3] The court granted relief with respect to unreported constructive dividends arising out of the corporation's payment of certain personal expenses incurred by the Purcells (Pet. App. 80-81, 89-97), and the Commissioner did not appeal. The court denied innocent spouse relief with respect to the failure to report income allocable to a covenant not to compete (*id.* at 81-84).

were not "grossly erroneous items" (Pet. App. 85-89). The court explained that the fact that petitioner had now conceded the correctness of the Commissioner's adjustments was "not sufficient to establish that the claimed deductions were in an amount for which there was no basis in fact or law" (*id.* at 85), and that petitioner had made no other showing to establish that statutory requirement (*id.* at 88). Noting that the company was in bad financial condition in the years in which the deductions were taken and that the accountant believed that he had sufficient information to justify the deductions, the court concluded that the deductions were not "phony" or "grossly erroneous" (*id.* at 88-89).

3. The court of appeals affirmed (Pet. App. 26-54). With respect to the worthless stock and bad debt deductions, the court agreed with the Tax Court that these were not "grossly erroneous items" (*id.* at 39-49). Pointing to the evidence of the severe financial straits in which International Demolition found itself in 1977 and 1978—including the facts that it stopped paying salaries to its officers and that many of its assets were liquidated—the court concluded that "there was both an arguable factual and legal basis for claiming [the deductions] in the tax year in which they were taken" (*id.* at 48-49).[4] The court rejected petitioner's contention that, under *Shenker* v. *Commissioner*, 804 F.2d 109 (8th Cir. 1986), cert. denied, No. 86-1247 (May 26, 1987), a deduction is "grossly erroneous" as a matter of law whenever the deduction is invalidated on the ground that it was not taken in the correct year. The court explained that petitioner's contention was based on a

---

[4] The court also affirmed the denial of the requested innocent spouse relief in connection with the covenant not to compete (Pet. App. 37-39). Petitioner does not challenge that aspect of the court's decision in this Court.

"misread[ing]" of *Shenker,* which held no more than that there was no basis in fact or law for the contention that the loss in that case occurred during the year in which the deduction was claimed (Pet. App. 42-43).[5]

4. Petitioner contends (Pet. 18-24) that the court of appeals erred in concluding that she was not entitled to innocent spouse relief in connection with the worthless stock and bad debt deductions. The basis for this contention appears to be the view that any deduction that is found to be taken in the wrong year must be held to be "grossly erroneous." Petitioner does not attempt to justify that interpretation of Section 6013, but she maintains that it has been adopted by the Eighth Circuit in *Shenker* and that this Court should grant certiorari to resolve the conflict in the circuits between this case and *Shenker.* The court of appeals correctly rejected both petitioner's interpretation of *Shenker* and her claim for innocent spouse relief. There is no conflict in the circuits and no basis for review by this Court.

a. There can be no doubt that the court of appeals correctly interpreted Section 6013 in holding that innocent spouse relief is not available in a case where the taxpayer had some basis for claiming a worthless stock deduction in a particular year. Congress's intent, embodied in the plain language of the statute and in its legislative history, was to limit innocent spouse relief to instances where the deficiencies stem from "grossly erroneous items".[6] When the items

---

[5] Judge Jones filed a concurring opinion in which he agreed with the majority's interpretation of the statute, but stated his view that petitioner had correctly read the *Shenker* decision (Pet. App. 50-54).

[6] The House Report gives as an example of the type of situation that Congress was intending to address a case where "one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony." H.R. Rep. 98-432, 98th Cong., 2d Sess. Pt. 2, at 1502 (1984).

do not fall into this category because they are supported by an arguable factual or legal basis, "it is likely that a fully informed spouse would have joined in the return" and thus there has been no "overreaching or dishonesty" by one spouse that needs to be addressed by innocent spouse relief (Pet. App. 44). When taxpayers on their joint return take a loss deduction for stock that actually became worthless and there is a factual and legal basis for taking the deduction in the year claimed, the deduction claim is not "grossly erroneous" or "phony," and the statute plainly precludes innocent spouse relief. Petitioner's suggestion to the contrary simply seeks to read the word "grossly" out of the statute; Congress could easily have made innocent spouse relief apply whenever a deduction is "erroneous," but it did not choose to do so.[7]

b. Petitioner's claim that there exists a conflict in the circuits is equally without merit. In *Shenker,* the Tax Court rejected two claims for innocent spouse relief in connection with two distinct deductions on the theory that the deductions were not "grossly erroneous." A deduction for certain business expenses was disallowed on the ground that those expenses were attributable to a corporation, not to the taxpayer. And a deduction for worthless stock was disallowed on the ground that the stock did not become worthless in the year in which the deduction was claimed. With respect to the latter deduction, the Tax Court ruled that, since the loss had in fact occurred at

---

[7] Petitioner is clearly mistaken in asserting (Pet. 23) that the effect of the decision below is to require a taxpayer to establish "fraudulent intent" on the part of the non-innocent spouse in order to qualify for innocent spouse treatment. A deduction may be "groundless" or "phony," even if there is no intent to defraud. See, *e.g., Douglas* v. *Commissioner,* 86 T.C. 758 (1986); *Sivils* v. *Commissioner,* 86 T.C. 79 (1986).

some point and the issue was merely one of timing, it could not be said that the deduction had "no basis in fact or law" (see 804 F.2d at 115).

On appeal, the Eighth Circuit affirmed with respect to the business expense deductions,[8] but it reversed the Tax Court's denial of innocent spouse relief in connection with the worthless stock deduction. The court explained that, since Section 165(g) permits a deduction only for losses "sustained during the taxable year," "there must be some basis not only for claiming that a loss occurred, but also for claiming that it was sustained during the taxable year in question" (804 F.2d at 115). Because the Tax Court's findings "ma[d]e clear that there was simply no basis upon which Mr. Shenker could claim that the loss of his stock occurred in 1971, rather than some later year," the court concluded that it was "grossly erroneous" to have taken the deduction in 1971 (*ibid.*).

The Eighth Circuit in *Shenker* thus held that the mere fact that a deduction is disallowed solely on the ground of timing does not preclude a finding that it was "grossly erroneous." But, contrary to petitioner's apparent contention, the court manifestly did not adopt the converse rule as an absolute—namely, that a deduction that is disallowed on timing grounds is *always* "grossly erroneous." Rather, as the court of appeals below correctly observed (Pet. App. 43), the Eighth Circuit merely held that Section 6013 also requires a court to consider whether there was any basis for the timing of the deduction claimed by the taxpayer. In *Shenker*, the court of appeals concluded, on the facts there, that there was no basis for the timing claimed by the taxpayer. In this case, by contrast, the court correctly con-

---

[8] The petition for certiorari in *Shenker* was filed by the taxpayer to seek review of this portion of the court of appeals' decision.

cluded that the accountant's independent judgment and the evidence of the precarious financial condition of the corporation in the years in question provided some basis for the timing claimed by the Purcells on their joint returns (Pet. App. 48-49). Plainly, the two cases turn on their individual facts, and there is no conflict between them.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

MARCH 1988

U.S. GOVERNMENT PRINTING OFFICE: 1988—202 037/60334